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Työn nimi-Arbetets titel-Title The Microeconomics of the Lender-of-Last-Resort Controversy			
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Tiivistelmä-Referat-Abstract A key issue in the discussion on banks' liquidity management is the question, why banks which have positive net present value (which are solvent), should find it hard to obtain finance from the market, ie be illiquid. Current theoretical models propose that liquidity problems by banks may arise due to co-ordination failure by outside investors (sunspot bank runs), or due to solvency shocks. We will argue that, if a bank is characterised by the possibility for moral hazard, liquidity problems may arise also absent any effects on bank solvency in non-panic situations. This happens when moral hazard problems are amplified in connection with the outflows of liquidity. The model suggests for a possibility that pure liquidity shocks can have real effects in banks' behavior and in the completion of investment projects. We will formalise our hypothesis by extending the framework introduced by Holmstöm and Tirole (1998), and use the extended framework to discuss optimal reserve policy in banking under moral hazard. In particular, we will discuss the potential gains achievable in banks' reserve policy when the implementor of the policy is a centralised liquidity pool, a lender of last resort. The implications of the model as regards central bank policy are consistent with empirical regularities observed in the development of LLR activity during the 1900's. In particular, the model rationalises the observed shift from adherence to strict Bagehotian principles to more supportive LLR assistance.			
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